REPUBLIC OF CROATIA
FISCAL POLICY COMMISSION

24 November 2021

15th Position Paper of the Fiscal Policy Commission on the Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024

At its 10th session held on 24 November 2021, the Fiscal Policy Commission (hereinafter: Commission) discussed the Draft State Budget of the Republic of Croatia for 2022 and the Projections for 2023 and 2024.

The Fiscal Policy Commission supports the Draft State Budget for 2022, the year in which fiscal rules will still not be applied. The Commission warns of the risk of exceeding expenditures in certain categories and reiterates that the period of intense growth should be used for enhanced fiscal consolidation. The key to fiscal sustainability is a strong economy which requires reforms and investments, relying on EU funding.

In its position on the draft budget, the Commission expressed its opinion on the continued temporary postponement of the application of fiscal rules in 2022, macroeconomic projections, the draft state budget and the evaluation of fiscal rules in 2023 and 2024 when it is expected that fiscal rules might be reinstated.

Continued temporary postponement of the application of fiscal rules in 2022

In accordance with its duties defined in Article 22 of the Fiscal Responsibility Act (FRA), and on account of the exceptional circumstances referred to in Article 10 of the FRA, the Commission continued with the temporary postponement of the application of fiscal rules defined in Articles 6, 7 and 8. On 2 April 2020, based on the Commission's opinion of 30 March 2020, the Government adopted the Decision on the temporary postponement of the application of fiscal rules in 2020[1], enabling measures to mitigate the effects of the epidemic on the citizens' health and the economy, which contributed to a faster recovery of economic activity.

Additionally, in its 10th Position Paper of 2 November 2020 on the Draft State Budget for 2021,[2] the Commission supported the continued postponement of the application of fiscal rules in 2021 on account of significant macroeconomic risks and uncertainties related to the epidemic that might negatively affect the achievement of the planned income and necessitate further fiscal measures to mitigate the consequences of the epidemic. The Commission warned that, in doing so, fiscal sustainability in the mid-term must not be jeopardized, which is why the provisions related to the postponement of the fiscal rules must be consistently followed, while fiscal measures must be short-term, efficient and aimed at fighting the effects of the epidemic.

Although it is not predetermined when and how the Decision on the temporary postponement of fiscal rules will be set aside, the Commission stresses the fact that this measure is a temporary one, and that, in preparing budgetary documents for the upcoming period, it is necessary to assume that fiscal rules will be relaunched after 2022. In other words, at the request of the Government of the Republic of Croatia, the Commission should also provide its opinion on the existence of extraordinary circumstances for 2022, as defined in Article 10 of the FRA, which make it necessary to continue the temporary postponement of the application of fiscal rules in 2022.

In establishing the existence of extraordinary circumstances, the Commission also examines the very event that led to the extraordinary circumstances, the impact on public finance, economic activity and the related risks, as well as the application of economic governance at the level of the EU.

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[1] Available at: https://narodne-novine.nn.hr/clanci/sluzbeni/2020_04_41_856.html.

[2] Available at: https://www.sabor.hr/sites/default/files/uploads/inline-files/10.%20stajali%C5%A1te_Povjerenstvo%20za%20fiskalnu.pdf

The Commission has established the following:

1. The coronavirus epidemic is still under way, and it is uncertain when it might end.
2. Therefore, medical intervention and fiscal support to vulnerable citizens and companies need to be reinforced further. However, since the expected level of fiscal support for 2022 is much lower than for 2020 and 2021, it could be treated as fiscal support related to an extraordinary event as is normally used in evaluating the fulfilment of fiscal rules.
3. After sharply declining in 2020 (-8,1%), Croatian economy recovered completely in 2021. Macroeconomic projections foresee the accelerated growth continuing in the upcoming years, but macroeconomic risks will still be significant because the epidemic continues.
4. In its instructions for preparing the Convergence Programme, in March 2021, the European Commission announced and confirmed in its Spring Forecast issued in May 2021[3] that the general clause on the postponement of the application of fiscal rules would continue in 2022, and invited the Member States to continue with the fiscal support in order to prevent an abrupt contraction of economic activity. Furthermore, at the level of the EU, a discussion continues on the reform of the economic governance framework and amendments to fiscal rules, and it is evident that changes will be introduced both to the framework and to the manner of its application.

Accordingly, the Commission holds that the improved economic situation in Croatia in 2021 indicates that the extraordinary circumstances referred to in Article 10 are less prominent and that the fiscal effects of the epidemic could be addressed through existing exemptions within the set fiscal rules. However, considering the continuation of the epidemic and the fact that fiscal rules are still suspended at the level of the EU under the general escape clause, the Commission holds that the existing circumstances allow for the temporary postponement of the application of fiscal rules to continue in 2022.

In that respect, the Commission underscores the need to pay special attention to mid-term sustainability of public finances, while additional fiscal spending measures must be

[3] Available at:
https://ec.europa.eu/economy_finance/forecasts/2021/spring/ecfin_forecast_spring_2021_hr_en.pdf

targeted, temporary and short-term. In 2021, certain deviations occurred to these guidelines and, in addition to those related to the epidemic, measures were also introduced on the income and expenditure sides with a permanent negative effect on public finances. Furthermore, it is necessary to continuously and carefully analyse the sustainability of public finances, first and foremost through the Report on the application of fiscal rules which is an integral part of all the Government's budgetary documents, regardless of whether the Decision on the temporary postponement of the application of fiscal rules enables temporary deviation from quantitative fiscal criteria or not.

The Commission also stresses that the period of accelerated growth, expected in 2022, must be used as a transitional period toward the consolidation of public finances and reinforcing economic resilience and potential, whereas the plans for 2023 and 2024 must be compliant with the existing fiscal rules.[4]

Macroeconomic projections

Pursuant to the FRA, the Commission considers the macroeconomic and budgetary projections from mid-term budgetary documents and compares them with the most recent available ones, EC's Autumn Forecast in this case.[5]

Macroeconomic projections incorporated in the Draft State Budget for 2022-2024 include results in terms of growth of personal and national spending, as well as tourist activity throughout the summer months of 2021 which are better than expected in the previous forecast from the Convergence Programme[6] and Economic and Fiscal Policy Guidelines[7]. In 2021, the Government expects economic growth of 9 % which would result in a complete recovery of economic activity, after it decreased by 8.1 % in 2020,

[4] This includes following the EC's instructions on the application of fiscal rules for 2023 expected early next year.
[5] Unlike the Euro area member states where independent fiscal bodies prepare or endorse macroeconomic projections, the FRA does not include such a provision.
[6] Available at https://vlada.gov.hr/UserDocsImages//2016/Sjednice/2021/Travanj/55%20sjednica%20VRH/Dokumenti%20NOVO//55%20-%202%20Program%20konvergencije.pdf
[7] Available at https://vlada.gov.hr/UserDocsImages//2016/Sjednice/2021/srpanj/71%20sjednica%20VRH//71%20-%207%20Prijedlog%20smjernica.docx

and its return to pre-pandemic levels. It also expects economy to continue growing faster than the potential growth in the upcoming years, i.e. by 4.4 % in 2022, 3.7 % in 2023 and 3.1 % in 2024. These high growth expectations include significant positive effects of the National Recovery and Resilience Plan (NRRP)[8]. GDP growth will be based on increased domestic demand, while net foreign demand is expected to have a slightly negative contribution. With the expected increase of deflators, in 2021, GDP expressed in the current prices will exceed the level from 2019, and nominal GDP will also continue its strong growth in the upcoming years.

Based on its latest available Autumn Economic Forecast[9] published on 11 November 2021, the EC expects similar trends and dynamics as the Government of the Republic of Croatia. However, the EC expects that GDP will increase by 8.1 % in 2020, and that recovery back to pre-pandemic levels will be achieved in early 2022 when GDP will grow by as much as 5.6 %, and that strong growth will continue in 2023 (3.4 %). In that respect, the EC expects a slightly slower growth of the deflators in the upcoming years, including a lower nominal growth rate.

The macroeconomic projections of the Government of the Republic of Croatia and the European Commission presented in Table 1 indicate that the Croatian Government and the EC both predict a very fast economic recovery after the slump in 2020. In that regard, the Croatian Government predicts that such recovery will already be achieved in 2021, while the EC projects it for 2022. In other words, their projections for 2021 and 2022 differ only in terms of the speed of recovery in 2021and 2022, as evident from the aggregate of real growth by 2023, which makes them almost identical.

[8] Available at: https://planoporavka.gov.hr/UserDocsImages/dokumenti/Plan%20oporavka%20i%20otpornosti%2C%20srpanj%202021..pdf?vel=13435491

[9] Available at https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2021-economic-forecast_en

Table 1 Comparison of macroeconomic projections of the Croatian Government and the European Commission

	Government				*EK*			*Difference*		
	2021	2022	2023	2024	2021	2022	2023	2021	2022	2023
GDP	9.0	4.4	3.7	3.1	8.1	5.6	3.4	0.9	-1.2	0.3
Aggregate	9.0	13.8	18.0	21.7	8.1	14.2	18.0	0.9	-0.4	0.0
Deflator	2.4	2.6	2.3	2.2	2.4	2.1	1.9	0	0.5	0.4
Nominal	11.6	7.1	6.1	5.4	10.7	7.8	5.4	0.9	-0.7	0.7
Aggregate	11.6	19.6	26.8	33.6	10.7	19.3	25.8	0.9	0.2	1.1

The Commission concluded that macroeconomic projections of the Croatian Government do not significantly deviate from EC's projections for the next two years, and holds that the proposed projections of the Croatian Government are appropriate. The Commission also underlines the need for the Government to carefully monitor the achievements of macroeconomic fluctuations and utilization of EU funds to be able to adjust them in a timely manner in case of any deviations.

Evaluation of the Draft State Budget for 2022 and the Projections for 2023 and 2024

Total state budget income is planned in the amount of HRK 164.5 billion in 2022 and HRK 167.7 billion in 2023 and 2024. Total income in 2022 includes a planned increase of surtax from value added tax and contributions, and especially aid (which is expected to increase by as much as HRK 8.3 billion). Income trends are adjusted to macroeconomic projections, and the Commission holds that the projection of income is realistic.

Total planned expenditure in 2022 financed from all the sources amounts to HRK 173.8 billion and exceeds the total expenditure planned by the last amending budget from October 2021 by HRK 0.5 billion, whereas the total expenditure planned is HRK 169.8 billion for 2023 and HRK 166.5 billion for 2024. Expenditures financed from sources that affect the result of the general government budget in 2022 are planned in the amount of HRK 127 billion, which is a decrease compared to the last amending budget from October 2021 in the amount of HRK 5.6 billion. These fluctuations are primarily conditioned upon the significant decrease of the transfer of budget funds to the Croatian Health Insurance

Fund, subsidies paid out to businesses for retaining employees, funds for remediation of hospitals' debts and one-off payments to pension beneficiaries.

On the other side, a significant increase can primarily be seen in the expenditure related to the consequences of the earthquake, the social welfare system, pensions and the pension system as well as interest on bonds and loans. This kind of planning foresees that the overall result will lead to a significant decrease of the state budget deficit which is estimated, in 2022, at HRK 9.3 billion (2.1 % of GDP, with a tendency to further decrease in the upcoming years: to HRK 2.1 billion or 0.4 % in 2023 and HRK 1.2 billion or 0.2 % in 2024).

Despite the planned decrease of expenditure affecting the deficit due to the abolishing of a number of epidemic-related expenditure categories, the Commission is of the opinion that significant risks are present that might lead to exceeding the planned amounts, exactly in those categories where the plan often goes through the roof. For this reason, savings are planned for next year because of the exclusion of funds for the recovery of the healthcare sector (HRK 4 billion), and the discontinuance of the support for the economy (app. HRK 4.2 billion) which might be necessary again if an urgent reform is not implemented and the epidemic continues. In addition, certain expenditure categories, especially the expenditure for employees and pensions, are again planned in the amount which will probably be insufficient because it depends on the outcome of collective negotiations.

Defined as above, the Draft State Budget for 2022 and the projections for 2023 and 2024 indicate an intention to quickly consolidate public finances and respect the reference level of 3 % of deficit which, however, might be exceeded. According to the ESA methodology, a general government deficit is projected in the amount of 2.6 % of GDP for 2022, decreased to 2.4 % in 2023, and to 1.6 % in 2024. These fluctuations of the general government budget in 2022 are mostly affected by the planned deficit within the framework of the state budget and the budget for local and regional self-government units. However, in case of achievement of the risks indicated on the expenditure side, the planned deficit might be exceeded. In addition, after public debt reached a new high, as measured by the share in GDP, in the amount of 87.3 % in 2020, its decrease to 83.1 % is planned in 2021 and its further decrease to 80.7 % in 2022, 78 % in 2023 and 75.3 % in 2024.[10]

Evaluation of the fiscal situation

Fiscal rules are a facility for the achievement of the objective of the Fiscal Responsibility Act, which is to ensure long-term fiscal sustainability. In the circumstances of a great economic shock caused by the coronavirus epidemic, strong fiscal support was necessary to mitigate the negative consequences for the people and the economy. The price of the implemented successful intervention, which resulted in a very quick economic recovery and a resumption of the growth trend, is an increased public debt and state budget deficit. Since accelerated economic growth is expected in the upcoming years, when additional and significant fiscal support will no longer be necessary, the Commission highlights that fiscal consolidation must be launched as soon as possible, under the condition that it does not jeopardize structural reforms and investments necessary to ensure intensified economic activity.

The existing fiscal rules, as well as the expected amendments, represent an important instrument for ensuring such consolidation; therefore, the Commission reiterates that the existing Decision on the temporary postponement of the application of fiscal rules relates only to 2022 and that, pursuant to the expected high economic growth rates, following of the existing fiscal rules in 2023 and 2024 must be ensured in the upcoming period.

Since the Croatian Government did not depict the *structural balance* analyses in its budgetary documents, the Commission is basing its evaluation on the estimates from EC's Autumn Forecast. According to EC's forecast, after years of intense growth before the pandemic when the production gap was positive and very high, the big decline caused by the pandemic caused a production gap to drop in 2020 to -6.0 % of GDP, while economic activity below the potential level continued in 2021 amounting to -1.3 % of GDP. However, quick economic recovery and growth will result in a positive production gap amounting to 1.1 % in 2022 and 1.4 % in 2023. If the production gap calculated in this

[10] These public debt projections also slightly differ from EC's 2021 Autumn Forecast which foresees a share of public debt in GDP of 82.3 % in 2021, 79.2 % in 2022 and 77.9 % in 2023.

manner is applied to Government's projections, structural deficit will remain at the level of about 3 % of GDP until 2024 – as projected for 2021. Besides the indicated risks related to exceeding certain expenditure categories, these plans show that the projections for 2023 and 2024 do not foresee sufficient fiscal consolidation.

The purpose of the *expenditure rule* is to prevent the state spending (expenditure growth plus one-off measures on the income side), measured as the share in GDP, from increasing in the mid-term. According to the Commission's assessment, the growth in expenditure should not exceed the reference level.

The *debt rule* is crucial for long-term sustainability of public finances because it restricts the growth of current spending at the expense of future generations. According to the debt rule, public debt may not exceed 60 % of GDP, that is, debt must decrease on average by 1/20 of the amount above the reference level. Before the pandemic, Croatia fulfilled this rule, but, in 2020, public debt increased abruptly and reached a share of 87.3 % in GDP. According to budgetary projections, in the upcoming period, the Croatian Government is planning a decrease of the share of public debt in GDP at an average rate of 2.5 percentage points per year, which is much more than the minimum debt reduction requirement, meaning the public debt rule would be fulfilled.

Since this Position Paper focuses on 2022, the Commission supports the draft State Budget for 2022, but also calls on the Government to use the accelerated growth period for stronger fiscal consolidation by limiting to the greatest possible extent the adoption of fiscal measures with a permanent effect on expenditure. In doing so, it is important to secure resources targeted at investments and reforms necessary for increasing the potential growth rate, while maximizing the use of EU funds and minimizing the use of own funding, While preparing the Convergence Programme and budgetary documents for 2023, the Croatian Government is called on by the Commission to examine in more detail the structure of public spending and adopt such measures that ensure public finances are adjusted to the current and future fiscal rules.

Again, as many times before, the Commission underlines the need for improved planning and control of the expenditure and warns of the risks on the expenditure side (healthcare, employees, pensions, support for the economy). In a situation of accelerated population ageing, the concept of intergenerational solidarity is also jeopardized because, according to this concept, the costs of current spending are transferred onto future generations. It would therefore be beneficial to undertake key reform interventions, without endangering the basic settings of the pension reform that has already been implemented. The strongest emphasis is placed on the reform of the healthcare system so that it does not generate additional losses which have been the subject of the amending State Budget year after year.

The key instrument of a stronger fiscal expansion are EU funds. High-quality, economically sustainable, strategic, and development- and reform-oriented projects based on EU funds as well as the EU Solidarity Fund must be used in the next seven-year budget period to impact economic growth and development of the Republic of Croatia. In other words, projects with the greatest potential for reforms and contribution for growth of potential GDP as well as an increase in fiscal sustainability are instrumental for the attainment of these plans. What remains the greatest threat to this plan is the low efficiency in contracting and withdrawing the funds. In conclusion, we can state that, considering the fact that fiscal sustainability was primarily related to economic growth, the lack of certain crucial reform interventions at the level of the Republic of Croatia will prevent stronger economic growth; therefore, the use of funding from the Recovery and Resilience Facility must be increased and, accordingly, as many high-quality projects as possible should be prepared.

The Commission session was headed for the first time by the newly elected Chairwoman, prof. Sandra Krtalić, PhD.